Universität zu Köln
Arbeitsstelle für Entwicklungsländerforschung
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Detlev Holloh

FINANCIAL SYSTEMS DEVELOPMENT AND LOCAL FINANCIAL INSTITUTIONS IN INDONESIA

Introduction and Selected Bibliography

Universität zu Köln
Arbeitsstelle für Entwicklungsländerforschung
Bernhard-Feilchenfeld-Str. 11, 50969 Köln
Tel.: 0221-470.4078, Fax: 0221: 0221-470.5195

University of Cologne
Development Research Center
Bernhard-Feilchenfeld-Str. 11, D-50969 Cologne
Tel.:++49-221-470.4078, Fax: ++49-221-470.5195

seibel@uni-koeln.de

From State-led to Market-led Development of the Financial Sector

The interventionist rationale of economic policy-making in Indonesia was already laid down in the 1945 constitution, but only the abundant oil revenues during the oil boom period between 1973 and 1982 enabled the government to realize the envisaged state-led model of development. In order to channel revenues to domestic industries, state enterprises and cooperatives, the government strengthened the position of state banks vis-à-vis the private sector. By 1982, state banks accounted for 80 % of total banks assets and 85 % of total bank credit. The central bank established a system of 32 subsidized liquidity credit programs at controlled interest rates. More than 90 % of liquidity credit, which made up almost half of the total loan amount disbursed during the oil boom period, were channeled through state banks. By 1982, small-scale credit accounted for almost one quarter of the total loan amount channeled through subsidized liquidity credit programs. The rural financial system was virtually closed for the private sector. *Bank Rakyat Indonesia* (BRI) was instructed to establish an extensive network of village units for the implementation of the subsidized credit programs.

During the 1980s, the negative consequences of this development model became apparent. The abuse and repression of the financial sector had undermined the mobilization of domestic savings and the institutional viability of state banks. Unsound lending practices, misallocation and misuse of funds and the consequent high default rates prevailed in most programs involving small-scale, rural and cooperative credit. BRI village units, which had been the major channel for subsidized credit programs, operated at high losses and were near to collapse. The BIMAS rice intensification program collapsed with at least 20 % of the total loan amount being uncollectible. Village cooperatives, which had to implement 19 subsidized credit programs, had become a field of appropriation for local officials and richer farmers. While the government had intended to supplant informal finance by subsidized credit programs, informal finance flourished because the vast majority of the rural population was not reached with these programs.

The collapse of oil prices in the 1980s diminished the government's development budgets and undermined the state-led model of economic development. "Back to the Wisdom of the Market Economy" (Coordinating Minister for Economic Affairs, Radius Prawiro, *Jakarta Post* 16.12.1989) became a major slogan of economic policy. In order to improve the competitiveness of domestic industries, stimulate non-oil exports, reduce reliance on state enterprises, and improve domestic resource mobilization several trade, investment and financial sector reforms removed restrictions that had contributed to the high-cost economy. The new market-oriented approach was most pronounced in a series of financial sector reforms. The first reform in 1983 removed credit ceilings, interest controls and 9 of 32 subsidized credit programs. Most entry barriers to the still state-dominated banking sector, including the rural financial sector, were removed in 1988, and in 1990 the number of subsidized credit programs was further reduced to four. The new banking law of 1992 put a general emphasis on market-oriented banking, removed the specialized functions of state banks and transformed them into limited liability companies. The financial sector responded vigorously to deregulation. Between 1988 and 1994 the number of banks increased from 112 to 240, the number of their branches from 1,640 to 6,059, and the number of rural banks and credit institutions from 5,783 to 9,196. Demand, time and savings deposits were boosted from Rp 37.5 to Rp 168.9 trillion, and the amount of outstanding credit from Rp 35.1 to Rp 153.9 trillion during the same period. The liberalization of financial markets constituted a watershed in the relationship between state and private domestic banks. By 1995, the private sector exceeded the state banks' share in savings mobilization and credit disbursement for the first time.

By the early 1990s the economy and the financial sector faced serious problems. The vast majority of state enterprises and officialized village cooperatives were deemed financially unsound; the exorbitant increase in money supply aggravated inflationary pressures and required a tight monetary policy; and increasing volumes of bad debts and widespread corruption in all business sectors became a major issue of public debate. Financial reforms had reduced existing distortions in financial markets, but new ones were added by further injecting government money into subsidized credit programs, obliging banks to allocate 20 % of their loan portfolio to small and medium enterprises, instructing state enterprises to allocate one to 5 % of their profits to small enterprises and cooperatives, and pressuring private companies to transfer up to 25 % of their shares to cooperatives. The scandals and crises of several private banks revealed that they had exceeded legal lending limits in extending loans to their own shareholders, who were connected to large business conglomerates. By the end of 1992, 15 % of the state banks' loan portfolio was categorized as non-performing. Business collusion between the bureaucratic elite and private conglomerates and priority credit programs with arrears ratios of 20 % or more were the major reasons for this performance. High arrears ratios occurred mainly in credit programs implemented through village cooperatives. The farmers' credit program (KUT) incurred arrears (29 %) mainly through the misuse of funds by officials of local government and cooperatives. The KIK/KMKP small-scale credit program was abandoned in 1990 with a default rate of about 27 %. The subsequent KUK credit program, through which banks were forced to allocate 20 % of their portfolio to small businesses, became also subject to manipulation.

Financial Sector Reforms 1983 - 1992

June 1983: 1. major banking reform: removal of all credit ceilings; reduction of subsidized priority credit programs (from 32 to 23); removal of deposit and lending interest rate controls; removal of subsidies on state banks' deposit rates.

1984-1987: Reintroduction of Bank Indonesia Certificates (SBI) to support open market operations (Febr. 1984); introduction of money market instruments (SBPU) - promissionary notes of bank customers, banks, NBFIs and trade bills (Jan. 1985); raising of interest rates for SBPUs, SBIs, discount facilities and swap premium in order to improve fund management (May 1987).

Oct. 1988: 2. major banking reform: removal of entry barriers for banks and the expansion of branches; allowing public enterprises to place up to 50% of their deposits outside of state banks; permitting banks and NFBIs to raise capital in the stock market; easing entry to leasing, insurance, venture capital, consumer finance, and securities activities; reducing reserve requirements From 15% (for demand deposits) and 10% (for savings and time deposits) to 2%.

1989: Introduction of legal lending limits, joint venture capital ownership and bank mergers; new definition of bank capital, reserve requirements, bank investment in stocks (March); Jakarta Stock Exchange decontrolled and privatized (Dec.).

Jan. 1990: 3. major banking reform: reduction of subsidized priority credit programs to 4; requirement for domestic banks to allocate 20 % of their portfolio to small firms and cooperatives; requirement for foreign and joint ventures to allocate at least 50% of their portfolio to export oriented activities.

1991: New measures to improve bank management and supervision (February); reimposition of ceilings on offshore borrowing for the public sector (November).

Jan. 1992: New banking law: general emphasis on market-oriented banking; removal of the specialized functions of state banks; transformation of state banks into limited liability companies.

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The Formal – Semiformal – Informal Sectors

The financial system in Indonesia consists of financial institutions and services which are conventionally classified as formal, semiformal and informal.

The **formal financial sector**, which is regulated by the banking law and supervised by the central bank, consists of state and private commercial banks, and *Bank Perkreditan Rakyat* (BPR). Between 1988 and 1993, the number of bank branches increased from 1,640 to 5,838, and the number of BPR from 178 to 1,709. Commercial banks operate in mainly urban areas, while only few have established mobile services for villagers. BPR operate on subdistrict level and are often referred to as rural banks. However, most of the new ones were established in urban and market centers and are not accessible to most villagers. The transformation of BRI village units into viable profit centers through market-oriented savings and credit schemes is a major success story of financial sector deregulation. The 3,213 units at subdistrict centers and 1,225 village posts reached about 11 million savers and 2 million borrowers, though many units do not yet reach the village level and serve a wealthier clientele close to urban centers.

The **semiformal financial sector** is not subject to the banking law but regulated and supervised by government agencies other than the central bank. It consists of mainly three types of financial institutions: *Badan Kredit Desa* (BKD), *Lembaga Dana Kredit Pedesaan* (LDKP), and *Koperasi Unit Desa* (KUD).

BKD are tiny village and rice banks in Java, which are supervised by the village head and BRI. The 5,345 units often consist of only a table in the village office.

LDKP operate either on subdistrict or village level, are regulated by provincial government law and are supervised by regional development banks. Among 1,978 of these institutions are the *Badan Kredit Kecamatan* (BKK) in Java with 510 units and 3,015 village posts, the *Kredit Usaha Rakyat Kecil* (KURK) in East Java with 222 units, the *Lembaga Perkreditan Kecamatan* (LPK) in West Java with 109 units, the *Lembaga Kredit Pedesaan* (LKP) in Lombok with 59 units, the *Lumbung Pitih Nagari* (LPN) in West Sumatra with 193 units, and the *Lembaga Perkreditan Desa* (LPD) in Bali with 631 units.

KUD are the officialized village cooperatives, which have been promoted to "village conglomerates" (*Infobank* 138/1991) and are involved in all sectors of the rural economy. By the end of 1988, only 104 of 7,873 KUD were self-reliant. Two years later, 2,092 of 8,535 KUD were categorized as self-reliant, but the vast majority would have had to close down if they were stripped of subsidies and preferential access to business deals with the government. KUDs were further shaken by corruption and bad debts and virtually exempted from financial deregulation. Subsidized credit to cooperatives boosted from Rp 340 billion in 1988 to Rp 2.5 trillion in 1993.

The **informal financial sector** operates outside of any regulation and supervision of state agencies. It consists of professional moneylenders, financial arrangements tied to land, labor and traded goods, financial arrangements between friends and relatives, and financial self-help groups. It was estimated that about 60 % of financial transactions in rural areas fall within this sector. However, the lack of empirically substantiated information makes it impossible to determine the relative importance of existing forms of informal finance within the financial system. The most recent empirical study found relatives and neighbors, professional money-lenders, rotating savings and credit associations and itinerant traders to be the most important sources of informal credit in rural areas.

Financial self-help groups are either *rotating savings and credit associations* (Roscas), in which members contribute regularly a stipulated amount that falls to one or several members by means of lot or according to an agreed order of rotation, or *savings and credit groups*, which build up a joint loan fund through capital shares, savings and net income from financial intermediation, intermediate between net savers and net borrowers, and provide loans at explicit interest rates and on explicit demand of their members. For Indonesia, there are only few empirical studies which deal explicitly with financial self-help groups. Clifford Geertz' study of the *arisan*, the Indonesian Rosca, is still a major reference for more recent publications. Regarding savings and credit groups (in Indonesia usually referred to as *simpan-pinjam* groups), I am aware of only one empirical study (Bongartz). Most of the latter groups are modern institutions, which were usually established with the support of non-government organizations in the 1970s and 1980s.

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LINKING BANKS AND SELF-HELP GROUPS IN INDONESIA

The idea of linking banks and financial self-help groups gained international attention when the United Nation's 'Third International Symposium on the Mobilization of Personal Savings in Developing Countries' emphasized the necessity of both formal and informal financial institutions for rural development, and recommended linkages between them. (United Nations 1986) As a follow-up and on the basis of an outline of basic principles of the linkage approach (Seibel 1985), the *Asia Pacific Rural and Agricultural Credit Association* (APRACA) and the German Agency for Technical Cooperation (GTZ) formulated the new program of *Linking Self-help Groups and Banks in Developing Countries* (Kropp et al. 1989).

Indonesia was the first country to translate the concept of linking banks and self-help groups into practice. A preparatory survey (Gadjah Mada University 1987) pointed to the development potential of financial self-help groups, on the one hand, and their limited capacity in meeting the credit demand of their members, on the other hand. On the basis, Bank Indonesia, Indonesia's central bank, elaborated the program proposal 'Linking Self-Help Groups and Banks to Promote Savings Mobilization and Credit Delivery in the Informal Sector in Indonesia' (Bank Indonesia 1987). Reviewing the strengths and weaknesses of formal and informal financial institutions, the proposal suggested the establishment of business relationships between banks, self-help promotion institutions (SHPI) and financial self-help groups. In late 1988, Bank Indonesia in cooperation with the German Agency for Technical Cooperation (GTZ) launched the linkage project with the **purpose** of *making viable financial services available to self-help groups of small farmers and entrepreneurs*, thus contributing to the improvement of the rural financial system in general. By July 1994 the training program had involved 2,300 bank and SHPI employees, and 11,000 board members of 3,700 self-help groups. 1,493 self-help groups had received an accumulated loan amount of Rp. 13.5 billion through the intermediation of 24 banks and 58 SHPI. (Bank Indonesia 1994)

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